

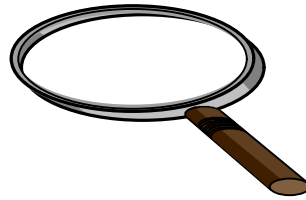
Contract Claims

A GUIDE TO

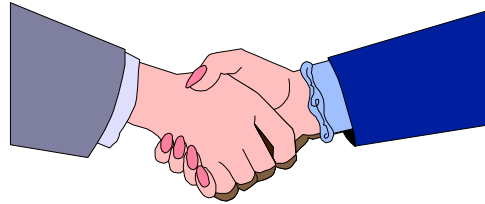
PREVENTION



EVALUATION



and SETTLEMENT



Financial Management Improvement Project

Federal Highway Administration

Southern Resource Center

PREFACE

CONTRACT CLAIMS

FINANCIAL MANAGEMENT IMPROVEMENT PROJECT

REGION 4

BACKGROUND

At an audit workshop, Region 4 State Department of Transportation (SDOT) auditors selected and recommended the study of contract claims as a subject for a Financial Management Improvement Project (FMIP). There were realizations that contract claims had increased in some States, both in number and dollar amounts. As a result of a contract dispute, SDOT auditors and engineers are requested to evaluate claims for additional compensation often without adequate and effective guidance¹. There is little written guidance/information (both State and Federal), on how to evaluate contractor costs on claims.

GOALS and OBJECTIVES

The goal and objectives of the FMIP were as follows:

Identify the reasons for contract claims.

Identify and evaluate the practices and procedures other Region 4 SDOT's use when reviewing and paying claims.

Identify successful SDOT practices used to minimize claims.

Develop a guide outlining the recommended procedures for preventing, evaluating, and settling contract claims.

APPROACH

An FMIP team approach was used which included both SDOT and Federal engineers, auditors and program officials. The team consisted of the following individuals.

John P. Jeffers - Federal Highway Administration (FHWA),
Region 4 Financial Program Coordinator.

Cecil Bragg - Florida Department of Transportation (FDOT),
Inspector General

¹See Attachment A for complete definition of a contractor's claim.

Ronald Carr - FHWA Tennessee Division, Project Management Engineer.

Bruce Dillard - North Carolina Department of Transportation, Manager, External Audit Branch.

John Greene - FDOT, Supervisor, Office of Inspector General Contract Audits.

Jimmy Lairscey - FDOT, Director of Construction.

Douglas Townes - FDOT, Area Engineer, Office of Construction.

During the information and evaluation phase of the FMIP, five Region 4 States were visited. At the site locations, FHWA Division, SDOT construction and audit personnel were interviewed. In two States, contractor association representatives were asked to provide their comments. Information was also gathered prior to the visits by obtaining the State's Standard Specifications, Construction Manuals and any other policy or a procedure document the SDOT may have had that gave some direction in the management of claims. The Region 4 States not visited were represented by the team members.

RESULTS

Following is the guide produced by the team with the recommended practices and procedures for the management of contractor claims. The specifics in the guide are what the team believes are the **BEST PRACTICES** for the prevention, evaluation and settlement of claims. Some of the recommendations in the guide are not regulatory and are of optional use by the SDOT's. One particular item, the use and inclusion of the Federal Acquisition Regulations (FAR), 48 Code of Federal Regulations (CFR) is a requirement. The referencing of the FAR should be included in FHWA regulations and the team through this report will request our Washington Headquarters Office to include this requirement in future updates to the Highway CFR's.

**a GUIDE for the
PREVENTION, EVALUATION and SETTLEMENT
of CONTRACT CLAIMS**

- I. Contract Claim Prevention
 - A. Project Plans
 - B. Project Administration
- II. Contract Claim Evaluation
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 - C. Overhead Resolution
- III. Contract Claim Settlement
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A GUIDE for the PREVENTION, EVALUATION and SETTLEMENT of CONTRACT CLAIMS

Introduction

The goal of all State Departments of Transportation (SDOT) is to deliver transportation improvements to the traveling public economically, effectively and timely. Contract claims can result in project completion delays and a costly resolution process that often do not benefit the SDOT or the contractor. In the following Guide, the Prevention, Evaluation and Settlement of claims will be discussed.

I. Contract Claim Prevention

Preventing claims should always be foremost in the SDOT management philosophy and controls. Even prior to the project resolution of the contractors request for additional compensation, are opportunities for the prevention of claims.

The causes of claims are varied and can frequently be attributed to behavior attitudes ranging from an individual to a departmental attitude. In the discussion of the prevention of claims, there will be suggestions and recommendations for training and partnership. The team observed during the site visits, it often appeared that a contractor's decision to submit a claim was subjective. A contractor may have had a long history of not filing claims, but some factor or factors changed the contractor's attitude toward the SDOT and claims started to be filed.

Based on the team interviews, we believe there are two factors most crucial in contract claim prevention. These are project plans and project administration. The reasons for our conclusions about these two factors and the recommended best practices are as follows:

A. Project Plans

Contractors bid on projects using the information they receive from the SDOT. Ideally, the contractor should be able to review the project site with the project plans, estimate the costs of labor, equipment and materials, and submit a reasonable bid. If successful as a bidder, the contractor should complete the project within specifications, on time, and within the cost parameters, barring any unforeseen major difficulties. The situation outlined above, particularly for more complex projects, is becoming more atypical.

Prior to bidding, a contractor may find plan errors in the bid package and if the contractor visits the project site, possibly even more plan errors could be found. A contractor can elect to contact the SDOT to have the plans corrected or clarified, or, the contractor could decide to bid on the project with the knowledge of the plan errors. Problems can arise when a contractor is not aware of, or, the SDOT does not have a central contact person to answer and evaluate the contractor's inquiries.

Deficient plans will carry over to the construction phase of the project. The beginning of the resolution of plan errors between the contractor and the SDOT is the responsibility of the construction project engineer. If the construction project

engineer cannot resolve the problem with an acceptable supplemental agreement or change order, the problem is escalated upward within the SDOT and delays can ensue.

In some cases, particularly when the SDOT can reasonably see that the delay will be lengthy, the SDOT must be **proactive**. Decisions must be made early to prevent claims, even to the point of terminating the contract. While termination may be costly in itself, the cost of a claim and potential litigation can be even costlier.

Listed below are three reasons given by SDOT officials for incomplete or inadequate plans.

- ! Downsizing of SDOTs has promoted out-sourcing of design functions in order to meet project production. Some SDOT officials claim that they do not have as much control over the quality of plans as in-house design plans.
- ! Some SDOTs have had plans prepared for a project only to see it delayed. Later, these older plans are taken "off the shelf," and are then used in the bid proposal package. Changes to the project site area can make the plan out of date.
- ! Systems such as computer aided design and drafting (CADD) systems can produce plans that fall short of intended quality. Program anomalies or improper input data can produce plans with errors that may not be easily detected.

Listed below are some recommended **best practices** to prevent the problems relating to plans:

1. Additional quality control reviews. While SDOT's are being downsized, they can enlist and partner with FHWA and other SDOT's. On particularly complex projects, a SDOT may solicit help from adjoining States (on an exchange basis) to review the plan and construction site.
2. Improve the Quality of Plans.
 - a. Perform a critical review of the plan product before acceptance and final payment to the private design firm. Return plans for correction and/or updating if necessary. Evaluate quality of work and use the ratings as a part of the selection process for future contracts.
 - b. Establish a central contact person to answer contractors' inquiries on plans.

- c. Require prospective bidders on all complex projects exceeding a certain dollar amount to perform on-site project investigations. Plan errors which are noted are brought to the attention of the Department and can be addressed before the letting. All prospective bidders are advised accordingly.
- 3. Open meetings with the construction industry. Prior to the bid process, SDOT's have invited interested contractors to an open meeting to discuss the project. This is a before the fact type of partnering and is usually called a "constructability review."
- 4. For selected projects, the SDOT should consider placing the bid in escrow. Escrow is the process where the bid documentation of the successful low bidder is preserved. Ideally, the documentation should be placed in escrow with a third party, such as a banking institution or other bonded storage facility. The purpose is to preserve bid documentation for use by parties in any claim or litigation. Projects should be carefully selected for this purpose and the procedure must be explicit and equitable.
- 5. Develop or use an available training program for all construction personnel on avoidance of claims and proper documentation when a notice of claim is filed.
- 6. Each FHWA Division Office should develop jointly with the SDOT, procedures for handling claims on Federal-aid projects.

B. Project Administration

When the project is underway, even with the best of plans, potentials for project disagreements surface. The first contractor's contact point in problem resolution at this juncture is the SDOT construction project engineer. The project engineer plays a critical role at this point and it has been recognized by SDOT's.

Some SDOT's report that certain construction project engineers have more problems, discounting project complexity, with contractors. Project delays due to intractable individuals can be costly. A particularly costly part of intractability is that the project engineer may be reluctant to refer the problem to a higher source. This could result in a larger problem as the project progresses.

In lieu of additional contractor compensation for extra work, some

construction project engineers have granted extra work days. While appearing to be a "no-cost" solution to a problem, it can be very costly both in time and money. Contractors have used the extra time granted as time delay and have filed a claim on that basis.

Listed below are some **best practices** for resolving problems in the area of project administration:

1. Construction project engineers may need training in teamwork and human relations. Managers should exercise appropriate oversight to ensure individuals do not exceed or abuse their assigned responsibilities.
2. One State DOT is empowering their project engineers and encouraging them to settle problems at the project level. For example, project engineers are authorized to approve any supplemental agreement/change orders up to \$100,000 per instance. SDOT upper management needs to institute controls to provide reasonable assurance that the project engineers' approval of supplemental agreements are well supported.

II. Contractor Claim Evaluation

Eventually a situation develops where prevention has not been successful and a contractor claim is filed. In order to maximize the SDOT's ability to manage the claim and minimize the impact on resources, it is important that the SDOT have procedures for processing claims, claim auditing and overhead resolution which are clearly understood and effective.

A. Processing Claims

All Region 4 SDOT's require contractors to state their claim in writing. At this point both the contractor and the SDOT need to understand the necessity of properly recording the situation. When the project engineer receives the written request for a claim, it is necessary for the SDOT to make a written response to the claim.

The contractor needs to understand that it is the company's responsibility to prove to the SDOT there was damage caused by a delay. The contractor is responsible for mitigating their losses from a delay. Depending on the length of the delay, a contractor may need to remove employees from the project and return rental equipment. It also may be recognized that the contractor could be obtaining extra work to absorb the overhead the company is claiming.

Listed below are the recommended **best practices** for the processing of contractor claims:

1. SDOT Specifications should include clear procedures for submitting a claim with specified time limits for the contractor and the SDOT at each stage of the process. The process should include a claim format and what may be claimed for labor, equipment, material, overhead, subcontractor costs, and profit. The claim should be written and accuracy attested to by the contractor.
2. The written response to the contractor² should be prepared with assistance from a qualified experienced claim processor, preferably from the SDOT Central Office. The project engineer should be briefed on the requirements of detailed documentation, such as workers on the job, equipment, etc. Additional documentation such as dated photographs and videos can also be of assistance to the SDOT if the claim

²Response to the contractor assumes the SDOT is in disagreement with the claim. That is not always so and there may be degrees of agreement or disagreement with the claim.

progresses. The additional claim documentation should be maintained at the SDOT central office for review and security.

3. When at all possible, review and settle claims while the project is still active. The claim factors will be more apparent and available at this time.
4. Claims record keeping at the Division/District level is very important to the SDOT and should be part of project engineer training and development.
5. The SDOT claims evaluation process should be centralized for uniformity and consistency. Persons responsible for claims management are clearly defined within the SDOT by location and title.
6. Within 30 days of notification of an "intent to file," the SDOT should initiate an internal compliance review at the project level to ascertain if departmental record keeping and other administrative claim requirements are being correctly performed.
7. A coordinator should be assigned to each claim. The assignment level within the SDOT depends on the dollar volume of the claim, i.e., the coordinator for claims more than \$1 million is the Division/District engineer whereas the project engineer is the coordinator for all claims less than \$1 million. This assignment remains with the position regardless of the length of the claim process or changes in personnel. All internal inquiries and request for assistance are automatically routed to the coordinator.

B. Claim Auditing

At this point, record keeping should be relatively straightforward. In most cases, the costs will be simply labor, equipment and materials. The contractor should understand, however, that a part of the project underwent a significant contract type change. A part of the contract went from a competitive bid contract to an actual cost contract. For a Federal-aid project, when there is a contract part separated from the competitive bid through a supplemental agreement, the 48 Code of Federal Regulations (CFR), Part 31 Federal Acquisition Regulations (FAR), Cost Principles for Commercial Organizations will be used to determine the eligibility of costs. These Cost Principles are very specific on eligibility of cost items. The cost principles become important, particularly if the contractor plans to claim home office overhead. Contractors need to know in advance that if the claim progresses, an audit may be necessary

and extensive detailed records must be made available to the SDOT auditors.

The claim portion of the project is now viewed in the FAR's as a cost-plus-fixed-fee project. Profit cannot exceed 10 percent of the contract's estimated cost, excluding the fee. After establishing the estimated cost, the fee cannot be increased unless the scope of the work increases.

Listed below are the **best practices** for claim auditing.

1. For a cost-plus-fixed-fee contract, the contractor is required to certify that the claims are true costs of the contractor. An example of a certification statement is included as Attachment B. The contractor should be made aware that false statements or claims are a violation of the Federal False Claims Act. In addition to the Federal law, many States have their own false claims acts. These laws typically have penalties associated with violations of the acts.
2. Criteria for allowable and unallowable claim costs should be well defined in the SDOT Specifications, along with the record access by SDOT auditors.
3. SDOT auditors should be proactive in the claims process and meet with SDOT engineers to understand the nature of the claims and ascertain the scope of the examination. Requests for audit assistance should be in writing and the audit/review report will be addressed to the individual(s) requesting the assistance.
4. The SDOT engineer should have access to an auditor or financial specialist who can evaluate the cost claimed. The auditor can evaluate the claim in accordance with the FAR's. This process should take place before any negotiations with the contractor take place.

C. Overhead Resolution

Home office overhead is normally claimed by the contractor as an additive to labor, equipment and material cost included in the claim. The additive rate is a stated percentage of each of the above costs and per the SDOT's Specifications, is also intended to provide reimbursement for all indirect job costs as well as home office overhead.

Home office overhead can also be computed by the contractor as a rate that can be equitably distributed over all jobs during a given accounting period(s). Without question, it is a very

controversial element of claims when the contractor makes a decision to claim **unabsorbed** home office overhead. The premise is, that because there was a delay, the contractor was not able to obtain other work to absorb these costs.

While formulas have been used for claiming unabsorbed home office overhead, these formulas have been questioned. The formulas have been questioned because a contractor may be under the impression that the cost of unabsorbed overhead is strictly based on formula, rather than actual cost.

Listed below are the **best practices** for overhead resolution.

1. Unabsorbed overhead, like all parts of the claim, must be costs that are verifiable (can be audited) and be recordable as an expense in the contractor's accounting records. A contractor needs to provide supporting documentation that the company suffered monetary damages due to lost business opportunities because of the imposed project delays by the SDOT.
2. An experienced SDOT auditor can be helpful to the contractor in explaining the cost principles and the computation of unabsorbed overhead costs, but it is not the Department's responsibility to determine the costs. The contractor may be advised to compute the cost either internally or through their accounting firm.
3. Rather than having a contractor develop an unabsorbed overhead rate, which would entail an audit, SDOT's should consider allowing the contractor to claim overhead cost of up to 15 percent. An amount up to 15 percent would be added to the direct cost of labor and materials. If this option is selected, quick agreement may be made with the contractor with reduced administrative costs for both the contractor and the SDOT.

III. Contractor Claim Settlement

In the contract claim definition, there are four basic ways a claim can be settled. These methods are discussed in the following paragraphs.

A. Negotiation

Negotiation is certainly the most desirable and the least costly for both parties. At this point, the SDOT and contractor both believe the claim can be settled by bargaining. Each side may be able to understand each others position and are willing to make compromises. This is where human relation and negotiation skills on both sides can really be beneficial. Negotiation works best at the project level.

B. Arbitration

Arbitration may have different names in different States. This process of settling disputes may be called a "review board" or a "hearing" and may or may not be binding on the parties involved. One SDOT offers a hearing process but the final determination is determined by the head of the Department. Generally, this process is described in a SDOT's Standard Specification. Documentation of the claim plays an important role in the arbitration process. In some States this is final administrative process to resolve claims within the SDOT.

C. Mediation

Mediation can be confused with arbitration. In this process, however, the SDOT and contractor are not talking with each other. The two parties have selected a skilled professional negotiator to present each side's position with the opposing side's offer. When mediation is used, the deciding points of settlement may not be based so much on documentation, but how much each side is willing to offer in reaching a settlement. In States where this has been applied, results have been less than satisfactory.

D. Litigation

Litigation, for contractor and SDOT alike, is the costliest and most time consuming. Both parties may hire counsel and the gathering of information for the court consumes both human and dollar resources. Unless there is some reason to establish a precedent setting case, this process is the least desirable for claim settlement.

IV. Conclusion

In this Guide, we provided information on the Prevention, Evaluation and Settlement of claims. For the Prevention and Evaluation of claims, we listed the best practices used by the Region 4 SDOT's, or practices the team believed would work either because of observation or through discussions with other SDOT partners. For the Settlement of Claims, we listed methods of settlement with our observations of best practices. From the best practices and observations, three common threads tie the recommendations together. These recommendations are:

A. Communication

Communication means a willingness to discuss project problems with the contractor. It also means a willingness to seek assistance within the SDOT as soon as practicable.

B. Pro-activity

Pro-activity is trying to settle the claim as soon as possible and at the lowest possible level. This means a willingness not to ignore a problem in hopes that it goes away. It will not!

C. Documentation

The commitment and willingness to document situations will pay off for the contractor and SDOT.

In producing the Guide we established a multi-disciplinary team with engineers (both SDOT and FHWA), auditors and a financial manager. While we had a team, we also had our partners. All of the SDOT, FHWA and contractor representative who provided input and assistance during the production of the Guide are truly partners in this project.

DEFINITIONS

Contract Claim: A written demand for additional compensation submitted by a construction contractor as a result of an adjustment, or an interpretation of contract terms, which could not be satisfactorily resolved by project administration. Claims can be settled by negotiation, mediation, arbitration, or litigation.

Definitions Below:³

Negotiation: To deal or bargain with another or others. To bring about by discussion a settlement of terms.

Arbitration: The hearing and determining of a dispute between parties by a person chosen or agreed to by them.

Mediation: To bring about an agreement as an intermediary between parties.

Litigation: To make the subject of a lawsuit; contest at law.

³Random House College Dictionary

CERTIFICATION

This is to certify that the statement of costs has been prepared from the books and records of the contractor named below; that the work has been performed according to the contract (supplemental agreement No.____), and the quantities and amounts involved are consistent with the requirements of the contract.

This request for payment does not include any costs which are unallowable under the cost principles of the Federal Acquisition Regulations. Unallowable costs include, but not limited to advertising and public relations costs, contributions and donations, entertainment costs, fines and penalties, lobbying costs, defense of fraud proceedings and goodwill.

All overhead or indirect costs if claimed on an actual cost basis, are properly allocable to contracts on the basis of a beneficial relationship between the expenses incurred and the contracts to which they are allocated in accordance with applicable acquisition regulations.

To the best of my knowledge and belief, the above statements are correct.

Firm:_____

Signature:_____

Name of Certifying
Official:_____

Title:_____

Date:_____